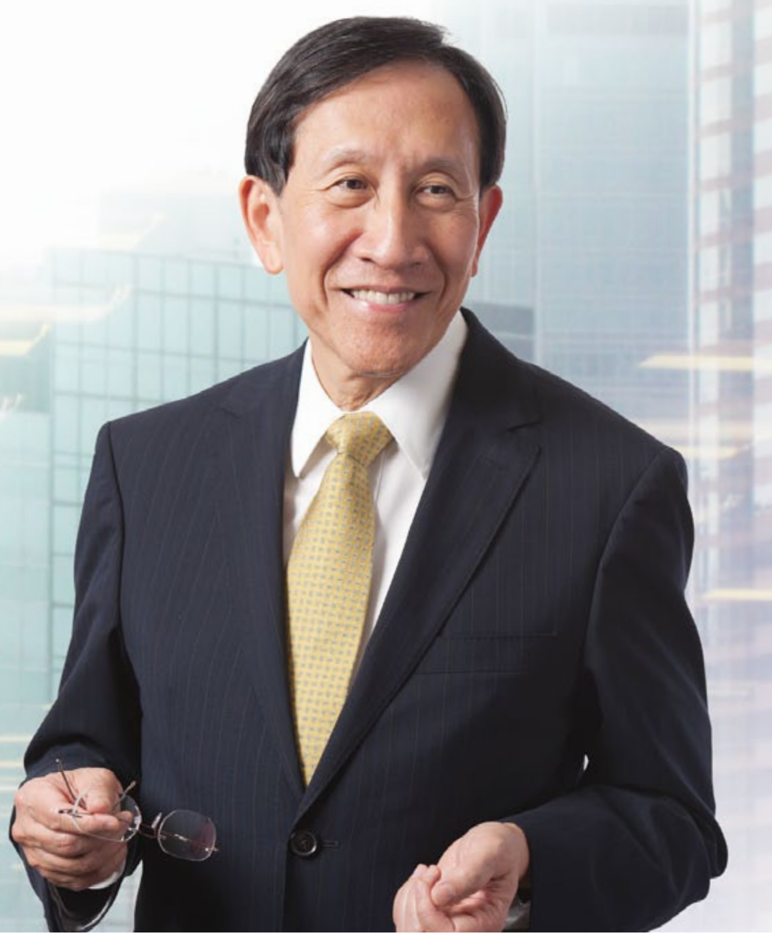
Chairman's Message



"Hong Kong must remain flexible, ready and willing to adopt and adapt to changing circumstances, and to act promptly and decisively in dealing with new risks and challenges."

The year started positively as global financial stability improved on the back of modest recovery in advanced economies and robust growth in emerging market economies. This changed as credit downgrades of eurozone economies and the US renewed concerns of recession and increased the risks to financial stability. Euro area action to ease funding and liquidity strains restored stability, but uncertainty remains whether stability is entrenched.

As a hub for international capital flows, and the gateway to Mainland China, Hong Kong is susceptible to the vagaries of global financial markets and developments on the Mainland. Over the years, it has withstood the swings in global economic cycles and the euphoria and gloom of global financial markets. Hong Kong overcame the challenges of the handover, the Asian Financial Crisis and the outbreak of the severe acute respiratory syndrome. Since 2006, when I came on board the SFC as chairman, I have seen how the global financial crisis has brought financial markets to the brink of total collapse and shaped global financial reforms that are changing the global financial landscape. Global financial markets have recovered but are yet to return to full normal functioning; markets have to be fully convinced that needed regulatory, fiscal and structural reforms will be implemented.

Challenging economic times

The global economy avoided a sharp economic slowdown following improved economic activities in the US and policies taken in the euro area. The economic recovery in advanced economies is fragile and may be weakened if the euro area debt crisis intensifies. In particular, there is concern over euro area banks' access to funding and the risk of deleveraging by banks if this becomes an issue, and the negative impact this would have on economic activity, growth and unemployment.

The economic environment is indeed challenging. In the euro area, the major challenge is to balance austerity measures against the need to generate growth and employment. The difficulty is that until markets are convinced that governments have a credible plan to contain fiscal deficits and reduce government debt, governments may have difficulty to spend more or roll over maturing debt at affordable borrowing rates. However, policy manoeuvre might be constrained by political realities. Important structural reforms that will help to create sustainable employment and increase competitiveness may also not get the needed popular support, given the pain of such measures.

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Emerging markets have been able to withstand the financial shocks and economic slowdown emanating from advanced economies. In Asia, there has been a pick-up in economic activity in early 2012, following last year's slowdown. However, if the situation of the advanced economies were to worsen, there could be a withdrawal of credit and cross-border lending, a sudden reversal of capital flows, and exports to advanced economies could experience a further sharp fall. As food and commodity prices have eased, inflation is not expected to be an issue, but policymakers have to remain watchful and act should signs of inflation return.

Implementing global financial reforms

Financial institutions operate across borders in a global marketplace. Financial regulators and supervisors operate very much nationally and regulations stop at the border. At the national level, regulators may not have a holistic picture or full understanding of the operations of financial institutions if they operate across financial markets. The global financial crisis brought to light regulatory gaps and the lack of oversight of macro-prudential and systemic risks. Global financial reforms address the need for a more integrated and holistic approach to regulation and the need for greater co-operation and information sharing among regulators, both nationally and cross-border.

The financial system is as strong as the weakest link. Financial regulators have to look beyond their traditional boundaries of regulation and gain an understanding of the changing nature and structure of financial markets and how their risks are interconnected in a global financial market. Equally important is to understand how the plumbing of the financial infrastructure works and how it creates linkages across the network of financial markets.

Global financial reforms are ongoing and the pace of progress differs depending on the nature and complexity of the issues, legacy issues, philosophical differences and local circumstances. National reform initiatives have advanced ahead, but often resulted in disparate reforms that create potentially conflicting rules and requirements. The challenges are not insurmountable and consensus can be achieved if one accepts that there is no "one size fits all" solution, and a willingness to seek a pragmatic way forward that achieves the desired regulatory outcomes while allowing for domestic circumstances.

It is important that the reforms do not create unintended consequences that increase risk rather than make markets safer, or result in overly burdensome rules that hinder the efficient functioning of markets; a balanced approach is imperative to promote market stability without hindering market development. It is also important that in fixing the last crisis, regulators do not lose sight of existential and emerging risks and issues.

The SFC actively participates in the different work streams of the International Organization of Securities Commissions, the standard setter for international securities regulation, which is an ideal forum for dialogue to address the regulatory issues that have cross-border implications for financial markets and find a pragmatic solution that achieves the desired regulatory outcome. As an international financial centre and the host of global financial institutions, Hong Kong supports the need for a common minimum international standard of regulation that promotes sound market functioning and market stability.The SFC will continue to maintain a robust regulatory framework that adheres to internationally agreed standards of regulation.

Global financial reforms are important and necessary but regulation alone is not sufficient. There is a need for shared discipline and responsibility by all stakeholders, including investors, intermediaries and regulators, to guard against excessive risk-taking and avoid a repeat of a crisis of such severity and magnitude as the global financial crisis.

Enhancing collaboration with mainland China

For the first time, the Mainland's latest Five-year Plan, released in March 2011, contains a separate chapter on Hong Kong. This signifies the Mainland's vision for Hong Kong to be an international asset management centre and offshore renminbi centre. It also represents the next important stage of mutual co-operation and collaboration between the two markets to further integrate mainland China with global capital markets and for Hong Kong to continue in its role as the platform for incoming and outgoing capital flows into and from mainland China.

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Hong Kong has successfully played this role since the Mainland started on its "going out" strategy. In recent years, Hong Kong has been the platform for Mainland intermediaries wanting to gain the experience of operating in an international financial centre that is benchmarked to international standards of regulation. This would help Mainland intermediaries to conduct their operations according to the standards and rigours of Hong Kong's market and regulatory regime. As these intermediaries have a deeper understanding of Mainland markets and enterprises, their knowledge is also invaluable to Hong Kong.

Hong Kong is an open economy with the traditions of sound institutions and the rule of law, which have underpinned its success as an international financial centre. Hong Kong and the Mainland have a symbiotic relationship that is mutually beneficial and complementary. The SFC will continue to work with the government and relevant Mainland authorities to facilitate the development of renminbi investment products that will support mainland China's goal to internationalise the renminbi.

The SFC has collaborated with other regulators in Hong Kong and the Mainland to establish the necessary trading and clearing infrastructure for renminbi-denominated products, and with the industry to get their systems ready for trading in these new products. Going forward, we will continue to build on this experience and welcome discussions with industry on their proposals to further develop this market. The SFC will continue to engage investors through our investor education initiatives to ensure that investor interests are safeguarded as renminbi products gain popularity.

Adopting and adapting for success

The highly open nature of Hong Kong's economy and its role as an international financial centre is reflected in its securities market, which has substantial international participation. Mainland enterprises account for more than half of its stock market capitalisation, with a growing number of overseas companies from an increasing number of countries seeking to list in Hong Kong. Overseas investors account for almost half of stock trading in Hong Kong, and funds from non-Hong Kong investors have consistently accounted for more than 60% of the Hong Kong asset management business.

Hong Kong's success as an international financial centre is a privilege; with it comes the responsibility to maintain the trust of investors. The SFC must remain vigilant in managing risks and in bringing appropriate action against market misconduct. It must keep the SFC's regulatory tool kit under constant review, and adopt new regulations or adapt its regulations as appropriate to ensure that they remain relevant and effective for Hong Kong in achieving the objectives of investor protection, fair, efficient and transparent markets, and orderly and stable markets. The SFC will continue to remain at the forefront of adopting and adapting international standards, and in responding to local issues in order to maintain a robust regulatory framework that promotes a sound and resilient securities market.

Hong Kong must remain flexible, ready and willing to adopt and adapt to changing circumstances, and to act promptly and decisively in dealing with new risks and challenges. This is important for Hong Kong to be able to absorb the shocks and challenges of an interconnected global financial market. The SFC will continue to maintain a balanced regulatory approach that promotes sound regulation without impeding market development.

Market participants and investors are important partners of the SFC in promoting and maintaining healthy and resilient markets. Market intermediaries must act with utmost professionalism and care in the conduct of their operations, in risk management and in dealing with their clients. To maintain the trust of investors and other market participants, they must act in line with the conduct and due diligence that is expected of them. Investors also must act with responsibility in making investment decisions. On its part, the SFC will continue to carry out its functions, including enforcing the law to punish and deter misconduct, and to reach out to investors through targeted investor education.

It has been another challenging year. I welcome Ashley Alder back to our fold as the CEO, bringing with him invaluable market expertise and insights. I am heartened that SFC colleagues have once again demonstrated a strong commitment to professionalism, excellence and diligence in their work and responsibilities. Their dedication has made my job much more enjoyable. I would like to express my appreciation and gratitude to the Board and all SFC colleagues for their continued support and steadfast commitment to the mission and objectives of the SFC.

Dr Eddy C Fong
Chairman